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Understanding China’s Crackdown on Bitcoin and ICOs

By **Claire Groden** Thursday, October 5, 2017, 8:30 AM

China put its red-hot cryptocurrency market on ice last month when it shut down bitcoin exchanges and banned initial coin offerings (ICOs), an emerging tactic through which cryptocurrency ventures raise capital by selling investors a percentage of newly released coins. With the Chinese Communist Party’s 19th national congress approaching—the every-five-years gathering is the nation’s most important political event—many Western commentators have suggested that the crackdown at least partially reflects the regime’s interest in strictly enforcing capital controls.

That desire may well be one regulatory motive, but state media reports both before and after the crackdown frame ICOs as one of China’s many bubbles in which unsavvy retail investors are preyed upon. As governments around the globe struggle to comprehensively regulate virtual currency—mostly by juggling regulatory perspectives of tax evasion and illicit finance—China’s crackdown highlights an underappreciated perspective: consumer protection.

ICO Fever

Globally, 2017 is shaping up as the year of the ICO. In the first half of 2017, cryptocurrency offerings raised an estimated $1.27 billion. ICO funding has surpassed early-stage venture capital funding; in July, ICOs raised $300 million compared with $200 million in angel and seed funding.

In China, token sales have been wildly popular. More than 100,000 Chinese investors bought new cryptocurrencies through 65 ICOs in the first half of 2017—often with little more information than a roadshow presentation and a white paper. According to one state media report (link in Chinese), a popular roadshow venue in Beijing’s tech district, Zhongguancun, hosted an ICO presentation almost every other day in August. A government report (link in Chinese) estimated that ICOs had raised 2.6 billion RMB (almost $400 million) during the first half of 2017. Regulators estimate that as much as 90 percent (link in Chinese) of those coin offerings involved fraud or illegal fundraising.

Few countries have comprehensive regulations regarding virtual currencies or coin offerings. Regulators have largely framed the issue as countering illicit finance and tax evasion. In the United States, the Financial Crimes Enforcement Network has applied anti-money-laundering program requirements to bitcoin exchanges, and the IRS has investigated transactions for tax evasion. In the European Union, the European Commission has recently sought to tighten regulations around virtual currency to prevent money laundering and terrorist financing. But China’s focus on virtual currencies as a potential consumer-protection problem emphasizes a regulatory angle that is only beginning to gain notice. In an investor alert in July, the Securities and Exchange Commission (SEC) addressed the risks of participating in ICOs after hackers stole the majority of coins in an offering known as the DAO, warning that “fraudsters often use innovations and new technologies to perpetrate fraudulent investment schemes.” The alert was perhaps the first regulatory move in the United States toward framing virtual currencies as an issue of consumer protection. The SEC followed up this week with what appears to be its first time filing fraud charges against two ICOs. In the wake of China’s action, South Korea banned ICOs as well, also citing the risks of fraud and speculation-driven overheating. The United Kingdom, too, released a statement less than a week after China’s ban that warned investors ICOs were “very high-risk, speculative investments.” But on the whole, consumer protection remains an exceptional, not common, driver of cryptocurrency regulation.

Chinese Markets Are Particularly Vulnerable

Chinese regulators’ suspicion of ICOs is not all that different from the SEC’s, but Chinese markets’ vulnerability to bubbles makes the risk more acute to regulators. Chinese state media report (link in Chinese) that investors piling on to token sales include an “auntie army” of middle-income older women who were beginning to invest their savings. One state media article (link in Chinese) reported that scores of groups on WeChat (an omnipresent messaging service in China) each hosted hundreds of aunties conversing about their ICO investments. “No one knows how huge this community is,” the article said, noting that the aunties traveled in hordes to ICO presentations. Some of these investors admitted to journalists that they weren’t investing in the projects’ inherent value but in the hype the presentations could generate.

Retail investors, and especially mom-and-pop investors—people with extra cash, little formal education and a voracious appetite for high-risk, high-reward investments—dominate Chinese financial markets. In 2015, slumping property prices and low interest rates drove retail investors toward stocks, fueling a speculative boom that was quickly followed by a market-shaking bust. Retail investors have been blamed for a variety of bubbles that, like whack-a-mole, have drawn attention and reaction from the Chinese government. Regulators imposed extraordinary limits on trading after the 2015 market rout. A boom in bitcoins last year—peaking with some 90% of global bitcoin transactions reportedly taking place in China—was moderated only when regulators put a four-month investigative freeze on bitcoin exchanges. Part of regulators' apprehension stems from recent unrest among amateur investors whose savings have disappeared in fraudulent investment vehicles and market crashes. Last year, investors in the failed Fanya Metal Exchange staged protests in cities across China, demanding that the government help recoup their losses. Against this backdrop, token sales are another mole threatening unsuspecting aunties' savings and the country's broader economic stability.

In the wake of the crackdown, Chinese news headlines focused on making an example of one ICO mogul in particular: Li Xiaolai, one of China's largest bitcoin holders, whose rags-to-riches story generated a massive following. Li launched his own cryptocurrency, PressOne, in July through an ICO that drew (link in Chinese) around 14,000 investors and more than $75 million without even publishing a white paper. To buy in, investors had to use bitcoin, ether or the then-weeks-old EOS coin—a cryptocurrency created by a June ICO that Li also backed. PressOne promised to build a decentralized content distribution platform off the EOS blockchain.

These ICOs created a self-stimulating profit for Li, as PressOne drove more investment in EOS. In all, the PressOne sale collected more than 30 million EOS coins. Meanwhile, the EOS offering has become one of the largest ICOs in the world this year, netting what some skeptics in China (link in Chinese) have called "$500 billion worth of air." The ICO is still ongoing (though no longer in China), and it broke records in July by raising $185 million in its first five days. While one Chinese headline in the days after the ICO ban asked whether Li was "an angel or a scammer" (link in Chinese), another called him a "fraudster on the road to financial independence" (link in Chinese).

In the Chinese government's moves against ICOs, bitcoin exchanges might simply have been collateral damage. Although bitcoin's speculative bubble has already cooled significantly, Chinese regulators have other reasons to be wary. Bitcoin's anonymity and decentralization make it a currency of choice for criminal activity and malware: the worldwide WannaCry attack hit tens of thousands of Chinese institutions and ransom was demanded in bitcoin. Given China's strict capital controls, the government's uneasiness with unregulated currency is no surprise. But in the state media reports that so harshly criticize Li and other ICO "fraudsters," bitcoin exchanges are barely mentioned. One article (link in Chinese) suggested that regulators held a "milder attitude" toward cryptocurrencies compared to token sales but think it is "better to mistakenly kill than to mistakenly let be."

In a recent op-ed in Caixin, Sheng Songcheng, a counselor to the People's Bank of China, portrayed the policy less harshly, arguing that "with the ICO chaos being cleaned up," blockchain enthusiasts can direct their energies into more productive outcomes. It's not a crackdown on the decentralized technology, he emphasized, but a necessary righting of the course of an unruly emerging industry. Perhaps other countries' regulators should take note.

Topics: China

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Claire Groden is the Program Associate at the Center on Law and Security at NYU School of Law. Previously, she studied law at Peking University as a Yenching Scholar. Groden has worked as a reporter at Fortune and a reporter-researcher at The New Republic. She holds an AB from Dartmouth College magna cum laude in government and Asian studies.